Subprime Litigation: Where Are The Actual Losses? An Update[1]

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Abstract: Multi-billion dollar write-downs of mortgage-backed securities have resulted in numerous lawsuits by allegedly defrauded investors against issuers and underwriters of such securities. The investors argue that they have suffered compensable losses based on the substantial declines in the paper "value" or "price" of their mortgage-backed securities, even where they have been paid the full income stream payments due to them. In this update, the authors review some key obstacles to such actions, look at emerging trends in pending cases, and argue that the write-downs may not necessarily reflect the type of "actual losses" necessary to support federal securities law claims.

Among the many legal issues that have come to the forefront in the "subprime" litigations following the global financial crisis are important questions concerning the appropriate "value" or "price" that may be assigned to residential mortgage-backed securities ("MBS"). When the original version of this article was published in January 2009, the government was actively considering the purchase of MBS on the books of various financial institutions as part of the Emergency Economic Stabilization Act of 2008, better known as the "bailout bill" or the "Troubled Asset Relief Program" ("TARP"). Among other things, TARP gave the Treasury Department authority to purchase MBS from financial institutions on terms and conditions to be determined by the Secretary of the Treasury. This authority - which ultimately was not used for that purpose - in turn prompted considerable debate concerning the price that the government should pay for these securities, particularly in light of the absence of a functioning secondary market for them.[2]

The challenges faced by the government in determining how to value the MBS holdings of financial institutions underscore questions concerning the viability of class and individual actions that have been filed by MBS purchasers alleging misstatements and omissions by issuers and underwriters of MBS offerings. These actions, some of which have already been dismissed and others of which are subject to pending motions to dismiss (based in part on the arguments raised in the original version of this article), have been brought primarily under Sections 11 and 12(a)(2) of the Securities Act of 1933 and allege that issuers and underwriters failed to disclose adequately the risks associated with

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[2] *See* "Bailout's Next Phase: Consumers," THE WALL STREET JOURNAL (Nov. 15, 2008). The Treasury Department instead used the initial installment of funds authorized under TARP to acquire equity stakes in various financial institutions. Although it is unclear what policy initiatives and/or shifts the Obama administration may announce in responding to the downturn, it now appears unlikely that the initially proposed governmental purchase of mortgage-related assets will come to pass.

the mortgages that were used to collateralize the MBS offerings and/or failed to conduct sufficient due diligence on those mortgages.[3]

The theory being advanced in these cases is that MBS purchasers have suffered compensable "losses" resulting from allegedly substantial declines in the market "value" or "price" of the purchased securities.[4] This is premised on the notion that the "paper values" or "marks" assigned to mortgage-backed securities pursuant to generally accepted accounting principles ("GAAP") can be properly construed as the "price" of the securities, and that declining GAAP "values" (which have resulted in write-downs on the books of some MBS investors) reflect the type of "loss" necessary to support securities claims, with the only remaining question being how to quantify and attribute these losses. Under this theory, the massive write-downs in the values of MBS portfolios over the past two and half years suggests that potential damages in MBS cases could run to many billions of dollars.[5]

Embedded in all of this, however, is the assumption that the appropriate reference point for determining whether an MBS purchaser has suffered a loss that is ripe for litigation (and the extent of any such loss) is the current "paper value" of the securities. The purpose of this article is to suggest that such a theory, which essentially applies to MBS cases the damages analyses found in traditional "stock drop" cases involving publicly traded equity securities, may not provide an appropriate or legally viable framework for seeking relief under the securities laws. This is because unlike equities, the inherent value of an MBS may not be the price at which it can be sold, but rather the yield or income stream that it generates.

The Nature of Mortgage-Backed Securities

With respect to equity securities, courts and commentators have had many occasions to address when an investor has been injured for the purpose of asserting a securities claim. Other than dividends (which companies are

[3] E.g., Luther v. Countrywide Home Loans Servicing L.P. et al., Case No. BC380698 (Calif. Super. Court); Luminent Mortgage Capital, Inc. et al. v. Merrill Lynch & Co., Inc. et al., Case No. 2:2007-cv-05423 (E.D.P.A.); Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp. et al., No. 08-cv-10446 (D.Mass); Plumbers' and Pipefitters' Local #562 Supplemental Plan and Trust v. J.P. Morgan Acceptance Corp. I, No. 08-cv-1713 (E.D.N.Y.); Massachusetts Bricklayers and Masons Trust Funds v. Deutsche Alt-A Securities, Inc., No. 08-cv-3178 (E.D.N.Y.); NECA-IBEW Health & Welfare Fund v. Goldman Sachs & Co., No. 08-cv-10783 (S.D.N.Y.); City of Ann Arbor Employees' Retirement System v. Citigroup Mortgage Loan Trust, Inc., et al., No. 08-cv-1418 (E.D.N.Y.); New Jersey Carpenters Health Fund v. DLJ Mortgage Capital, Inc., et al., No. 08-cv-05653 (S.D.N.Y.); Vasili Tsereteli and Vaszurele Ltd. v. Residential Asset Securitization Trust 2006-A8 et al., No. 08-cv-10637 (S.D.N.Y).

[4] For example, the *Luther* complaint alleges that "[t]he delinquency rates of the underlying mortgages has gone up tremendously and Countrywide Financial has taken huge write downs of its own residual interest in many of its Alt-A [a category of mortgages between prime and subprime] Trusts. As a result, the Certificates are no longer marketable at prices anywhere near the price paid by plaintiff and the Class, and the holders of the Certificates are exposed to much more risk than the Registration Statements/Prospectus Supplements represented." *Luther* Complaint at 3. Similarly, the *Nomura* complaint alleges that "[b]y the summer of 2007, the truth about the performance of the mortgage loans that secured the certificates began to be revealed to the public. ... As a result, the Certificates should receive less absolute cash flow in the future and will not receive it on a timely basis. As an additional result, the Certificates are no longer marketable at prices anywhere near the price paid by plaintiff and the Class, and the holders of the Certificates are exposed to much more risk with respect to both the timing and the absolute cash flow to be received than the Registration Statements/Prospectus Supplements represented." *Nomura* Complaint at 3.

[5] As of August 27, 2008, over 100 institutions had announced write-downs totaling over $506 billion, arising in part from estimated declines in the "value" of certain tranches of mortgage-backed securities.

not required to declare), equity investors make money by buying and selling securities at their trading prices. In other words, the value of an equity security (at least one that trades efficiently) is generally defined by the price at which it can be traded. The same may be true of corporate bonds, for which there are often liquid and stable secondary markets.

By contrast, mortgage-backed securities are not listed on exchanges; all trades are privately negotiated. Although a particular MBS offering may have many tranches that behave in very different ways (and have different payment and risk structures), each is in essence a contract that entitles its owner to certain portions of principal and interest from the pools of mortgages that serve as collateral for the offering.[6] In this sense, mortgage-backed securities are arguably more akin to bank loans and other collateralized commercial contracts than to equity securities, a fact reflected in the fundamentally different ways that they are sold, traded, and valued.[7]

The tranches in an MBS issuance typically contain certain forms of credit enhancement, including, for example, subordination, over-collateralization, and excess spread, each of which is designed to shield the securities they protect from loss of income due to mortgage defaults.[8] Thus, the credit risk of many MBS tranches is controlled so that it is lower than the credit risk of the underlying mortgages serving as collateral. In other words, defaults on mortgages underlying the bonds will not necessarily trigger a default of payment obligations on the bonds themselves. The structure of a typical MBS offering involves a payment "waterfall," whereby holders of various MBS tranches are paid in order of seniority. Senior tranches - those with the highest credit rating and lowest rate of return - are entitled to receive accrued interest and principal payments before junior tranches. At the same time, any losses incurred based on the performance of the mortgages underlying the securities are borne first by holders of the more junior tranches. Thus, an increase in mortgage default rates leading to lower than expected cash flows may still allow for payment in full to holders of senior MBS tranches.

Accordingly, an investor could buy a mortgage-backed security, continue to receive all principal and interest payments called for by the offering documents on the schedule set out in those documents, and yet at some point be required by GAAP to mark down the value of the security on its balance sheet based on prevailing (and fluctuating) market conditions. The same investor might have to revalue the security up or down, from time to time, and

[6] For a detailed overview of the subprime mortgage securitization process and the "frictions" at the root of the subprime crisis, see Adam B. Ashcraft and Til Schuermann, Understanding the Securitization of Subprime Mortgage Credit, WHARTON FINANCIAL INSTITUTIONS CENTER WORKING PAPER No. 07-43 (March 2008), available at http://www.newyorkfed.org/research/staff_reports/sr318.html0. For a detailed overview of the rating process for mortgage-backed securities, see Staff of the Office of Compliance Inspections and Examinations, Division of Trading and Markets and Office of Economic Analysis, U.S. Securities and Exchange Commission, Summary Report of Issues Identified in the Commission Staff's Examinations of Select Credit Rating Agencies (July 2008), available at http://www.sec.gov/news/studies/2008/craexamination070808.pdf ("OCIE Report").

[7] *See* SEC Release No. 33-8518: Asset-Backed Securities, 70 FR 1506, 1511 (January 7, 2005) ("SEC Release: Asset-Backed Securities") ("There are several distinguishing features between asset-backed securities and other fixed-income securities. For example, ABS [asset backed securities] investors are generally interested in the characteristics and quality of the underlying assets, the standards for their servicing, the timing and receipt of cash flows from those assets and the structure for distribution of those cash flows. … ABS investors also analyze the impact and quality of any credit enhancements and other support designed to provide additional protection against losses and ensure timely payments.").

[8] *See* generally OCIE Report at 6, *supra* note 6; SEC Release: Asset-Backed Securities, *supra* note 7.

may not know for some time whether it will in fact suffer an actual loss on its investment. As it turns out, although there have been defaults on mortgages that collateralize MBS offerings, because of the credit enhancements built into many of the securities, there are mortgage-backed securities whose "book", "prices" or "values" are perceived to have declined - resulting in portfolio write-downs required by governing accounting standards - but which simultaneously continue to pay principal and interest in full.[9] In such cases, the investor is holding a security that is providing 100% of the expected return, in precisely the form expected at the time of purchase. Exactly this issue has arisen in connection with the pending motion to dismiss filed by Credit Suisse Securities (USA) LLC in *Tsereteli*, which argues that publicly available reports confirm that all required pass-through payments have been made for the MBS at issue in that case.[10]

Despite that fact, is the fear that certain tranches of MBS might not be paid in full in the future a sufficient basis for bringing a claim under the '33 Act? Is such a claim actionable under the securities law and/or does it present a ripe case or controversy for the courts? And is the fact that some "paper measure of price" for the MBS tranche may have declined since the time of purchase enough to overcome these hurdles?[11] As discussed below, since the original publication of this article, these questions have been squarely presented by defendants seeking dismissal of securities actions brought by MBS investors, and definitive answers from the federal courts may be forthcoming.

MBS Offering Documents: Entitlements and Expectations

The tension of applying the loss standards articulated in equity securities cases to mortgage-backed securities is reflected in the expectations created by the terms and conditions of most MBS offering documents. These documents generally make clear that purchasers are buying interests in trusts whose assets consist of certain mortgage loans.[12] The investor is only entitled to the principal and interest payments from those mortgages, paid out at specified regular intervals in accordance with characteristics of the particular tranche

[9] In late 2008, Standard & Poor's projected that AAA mortgage-backed securities will likely see write-downs of less than one percent despite the more significant losses on the underlying mortgages. *See* Michael Kling, *S&P: Subprime Losses Will Be Much Lower*, MONEYNEWS.COM (Nov. 17, 2008). JP Morgan Chase & Co. analysts have also noted that "the [recent] dips in prices for senior tranches overstate credit risk" and that "mortgage securities rated AAA or AA probably won't lose principal in all but the most severe U.S. housing slump." *See* Jody Shenn, *High-Rated Subprime-Mortgage Bonds Cheap Enough, JPMorgan Says*, BLOOMBERG NEWS (Aug. 13, 2007). It has also been noted that the senior tranches "virtually never suffer credit losses," as only in the extremely unlikely event that losses exceed the amounts due to the holders of the junior tranches would the senior tranches absorb losses. *See* Kathleen C. Engel and Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending,* 75 Fordham L. Rev. 2039, 2044, 2047 (2007).

[10] Compare Tsereteli Memorandum of Law of Defendant Credit Suisse Securities (USA) LLC in Support of its Motion to Dismiss Plaintiffs' Amended Class Action Complaint, filed May 22, 2009 at 8-10 (Docket No. 32) (citing reports from MBS trustee indicating that all required payments had been made) with Tsereteli Amended Complaint (Docket No. 25) 104 ("Since the Offering, the Senior Certificates have experienced a material decline value, damaging Plaintiffs and the Class.").

[11] For the reasons discussed below, even if a plaintiff can overcome the hurdle of showing that it has suffered a legally cognizable loss, these same issues may present significant obstacles to class treatment of claims.

[12] For example, the offering circular for one 2006 MBS issuance provided that the issued securities "[represent obligations of and interests in a trust, whose assets consist of a pool comprised of closed-end fixed-rate mortgage loans and adjustable-rate, revolving home equity lines of credit mortgage loans, substantially all of which are secured by second liens on residential properties" and that these securities "[c]urrently have no trading market."

purchased. Purchasers are also warned that a secondary market for the securities may not exist and that investors may not be able to sell the securities at prices they might hope to obtain. For example, the list of risk factors in the Prospectus Supplement for a 2007 MBS issuance includes the following:

> A secondary market for the offered certificates may not develop or, if it does develop, it may not provide you with liquidity of investment or continue while your certificates are outstanding. Lack of liquidity could result in a substantial decrease in the market value of your certificates. ... The secondary market for mortgage-backed securities has experienced periods of illiquidity and can be expected to do so in the future. Illiquidity means that there may not be any purchasers for your class of certificates. Although any class of certificates may experience illiquidity, it is more likely that classes of certificates that are more sensitive to prepayment, credit, or interest rate risk will experience illiquidity.[13]

Similarly, the offering circular for another issuance provided:

> There is currently no market for the Offered Securities. The Initial Purchasers may make a market in the Offered Securities, but are not obligated to do so. There can be no assurance that a secondary market for the Offered Securities will develop or, if a secondary market does develop, that it will provide buyers of the Offered Securities with liquidity of investment or that it will continue for the life of the Offered Securities. If the Initial Purchasers are unable to sell all of the Offered Securities the Initial Purchasers have agreed to place, on the closing date, the Initial Purchasers have no obligation to purchase any Offered Securities. There have been times in the past where there have been very few buyers of similar asset-backed securities, and there may be similar times in the future. As a result, you may not be able to sell your Securities when you wish to do so or you may not be able to obtain the price you wish to receive.[14]

Disclosures of this type may make it difficult for MBS purchasers to successfully argue that losses should be measured by any decline in the "market value" of a particular mortgage-backed security. Because there can be no claimed expectation that the mortgage-backed security could be sold on the open market or that such a market even exists, the "market value" of any particular MBS may be deemed by a court to be irrelevant to whether a purchaser has suffered actual economic loss.

The standard terms of many MBS offering documents also disclose that intermittent losses and/or fluctuations in the value or performance of the underlying mortgages should be expected for a variety of possible reasons and that such losses, to the extent they are within a certain range, may not prevent payment in full to holders of some or all tranches. Indeed, as discussed above, mortgage-backed securities are structured to take this into account and allocate these risks to different tranches depending upon buyers' different appetites for such risks. This is an important issue that does not yet seem to have filtered into the current discussion - anyone who reads a typical MBS prospectus knows that (i) losses are expected on the mortgage collateral and (ii) not all such losses

[13] Prospectus Supplement on file with authors.

[14] Offering Circular on file with authors.

will affect payment in full of each tranche in the issuance (let alone effect them in the same way or at the same time).[15]

For example, one recent vintage prospectus supplement stated:

> Risks Related to the Offered Certificates. A decline in real estate values or in economic conditions generally could increase the rates of delinquencies, foreclosures, and losses on the mortgage loans to a level that is significantly higher than those experienced currently. This in turn will reduce the yield on your certificates, particularly if the credit enhancement described in this prospectus supplement is not enough to protect your certificates from these losses.
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> The subordination, over-collateralization, and loss allocation features described in this prospectus supplement are intended to enhance the likelihood that holders of more senior classes of certificates will receive regular payments of interest and principal, but are limited in nature and may be insufficient to cover all losses on the mortgage loans.[16]

Consequently, although an MBS purchaser can try to sell such a bond in a private transaction, many (if not most) MBS investors expect to make money by holding the bond through maturity and receiving the income stream they bargained for, not by trading on a secondary market or otherwise altering the type or nature of their holdings.[17] In light of these provisions, it appears clear that an MBS investor's bargained-for entitlement is limited to anticipated principal and interest payments, which must include some tolerance for foreseeable losses on the underlying collateral. To the extent that these amounts - the consideration for the contract that a mortgage-backed security represents - continue to be paid and there is no default on the bond, MBS purchasers may face, and in some cases have already faced, an uphill battle in convincing courts that they have suffered actual and actionable losses.

Valuing Mortgage-Backed Securities

Plaintiffs in MBS cases have begun to argue that such cases are ripe for adjudication and/or otherwise sustainable because the deterioration in the "market value" of their MBS holdings is an appropriate proxy for actual losses suffered.[18] But the manner in

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[15] To the extent any subprime MBS litigations survive pleading motions, these issues may arise in more detail when defendants oppose class certification.

[16] In the period after March 2007, many mortgage-backed security-offering documents also included additional disclosure such as "[i]n some areas of the United States, real estate values have fallen at a greater rate in recent years than in the past. In particular, mortgage loans with high principal balances or high loan-to-value ratios will be affected by any decline in real estate values. Real estate values in any area of the country may be affected by several factors, including population trends, mortgage interest rates, and the economic well-being of that area. Any decrease in the value of the mortgage loans may result in the allocation of losses which are not covered by credit enhancement to the offered certificates or notes." Prospectus Supplement, *supra* note 13.

[17] *See* SEC Release: Asset-Backed Securities, *supra* note 7.

[18] Interestingly, claims by MBS purchasers who are suing issuers and underwriters under the '33 Act may be at cross purposes with claims by shareholder plaintiffs bringing subprime-related "stock drop" cases against financial institutions. The former appear to be relying on "mark-to-model" prices as an accurate measure of accrued losses on their MBS portfolios. Conversely, shareholder suits challenging the integrity of a financial institution's own financial statements have questioned whether the models (and their underlying assumptions) used by companies for fair value measurements under FAS 157 were reasonable and valid.

which investors value their MBS holdings (under GAAP or otherwise) raises strong concerns about the reliability of such values. Where a company subject to GAAP buys mortgage-backed securities as an investment, GAAP requires the company to "mark" the securities for valuation purposes at certain regular intervals.[19] Statement No. 157 of the Financial Accounting Standards Board ("FAS 157") guides companies as to how they should measure the "fair value" of specific assets and liabilities (including instruments such as mortgage-backed securities) on their books in order to arrive at the appropriate marks. It provides that fair value should in the first instance be measured by the maximum price at which the asset could be sold in the principal market for the asset, or, where no principal market exists, the most advantageous market. Although FAS 157 favors valuations based on external, observable, and independent market participant assumptions, assumptions by companies themselves will suffice where there is minimal or no market activity from which to otherwise derive fair value measurements.[20]

Because mortgage-backed securities are not publicly traded and may experience periods of illiquidity, especially under current market conditions, fair value measurements are often obtained via a complex modeling process that takes into consideration predictions about the economy (such as short-term and long-term interest rates) and the expected performance (*e.g.*, default and prepayment rates) of the particular mortgages underlying a given security.[21] Thus, for purposes of valuing complex debt instruments like mortgage-backed securities, mark-to-market accounting is sometimes described as "mark-to-model" accounting.

A "mark-to-model" price may be theoretical and subjective, and may or may not represent (i) what someone would actually pay for the security were it to be sold or (ii) whether it can be sold at all. Although the models used by many companies have over the past two years resulted in decisions to significantly write down values of MBS portfolios, there is no guarantee of consistency or transparency from one company to the next. Some models may rely primarily on externally generated assumptions, whereas others may rely on internally generated assumptions. There may also be a lag time in the ability of some companies to adjust their models (or even create models) to take into account prevailing conditions. As a result, different investors (including plaintiffs or putative class members) could simultaneously carry the same or similar securities on their books while ascribing different values to them.

These concerns have been reinforced by the TARP program and the related comments of various government officials. Federal regulators recognized that the extensive "paper losses" suffered on MBS portfolios held by credit unions – as a result of the application of GAAP - would likely be reversed when the housing market stabilizes, and that at least one identified credit union had received all payments of principal and interest due to date on its senior tranche MBS

[19] The Financial Accounting Standards Board ("FASB") deems a mortgage-backed security to be "held for investment" where the investor intends to hold the loan until maturity. *See, e.g.*, FASB, *Statement of Financial Accounting Standards No. 134, Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise - an amendment of FASB Statement No. 65* (Oct. 1998).

[20] FAS 157 essentially ranks the quality and reliability of information used to determine fair values. Under the hierarchy it establishes, quoted prices are deemed the most reliable valuation indicators and model-generated values that rely on unobservable data are deemed the least reliable.

[21] *See* Jacob Boudoukh et al., *The Pricing and Hedging of Mortgage-Backed Securities*, in ADVANCED FIXED-INCOME VALUATION TOOLS (Narasimhan Jegadeesh and Bruce Tuckman eds., 2000).

holdings.[22] This conclusion was buttressed by the Treasury Department's consideration of reverse auctions as a means to establish market values for mortgage-related assets that it may choose to purchase from financial institutions.[23] Such contemplated auctions reflect the belief that the "marks" assigned by many entities to their MBS portfolios may be inaccurate in light of the income stream that the mortgages underlying these securities are expected to generate.[24] Indeed, Federal Reserve Chairman Bernanke and others have acknowledged that the "paper losses" ostensibly suffered by some MBS purchasers may reflect unrealistically low valuations of MBS based on market fears.[25]

The Requirement of "Actual Loss" Under the Securities Laws

The securities laws, and the '33 Act in particular, were designed for securities that trade on intermediated markets such as the NYSE and NASDAQ, not for privately-traded asset-backed securities (such as MBS) whose inherent value is tied to contractual payment rights. Indeed, in cases involving equities, the question of whether an investor has suffered a loss is often a forgone conclusion. The existence of efficient and active markets for many equity securities means that the "price" of such a security at

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[22] *See* Mark Maremont, *Mortgage Market Trouble Reaches Big Credit Unions*, THE WALL STREET JOURNAL (Aug. 11, 2008). Acknowledging the discrepancy between GAAP-required "mark to market" values and the long-term value of mortgage-backed securities for which there is no discernible market, some lawmakers lobbied the SEC to suspend the "mark to market" or "fair market value" rules and allow financial institutions to mark MBS portfolios based on long-term projections of their value. *See* Marcy Gordan and Stephen Bernard, *Banks Want to Suspend Accounting Rule in Bailout*, ASSOCIATED PRESS (Oct. 1, 2008).

In April 2009, FASB issued FSP FAS 157-4, which relates to determining fair values when there is no active market or where the price inputs being used represent distressed sales. According to FASB's press release, FSP FAS 157-4 "reaffirm[ed] the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive." *See FASB Issues Final Staff Positions to Improve Guidance and Disclosures on Fair Value Measurements and Impairments* (Apr. 9, 2009) (available at http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176154545286) (last visited Nov. 26, 2009). FASB has continued to study these issues. *See* FASB Issues Exposure Draft for Proposed Accounting Standards Update, Improving Disclosures about Fair Value Measurements (Aug. 28, 2009) (available at http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176156434356) (last visited Nov 26, 2009).

[23] *See* Justin Lahart, The Financial Crisis: Economists Look at Ways to Structure Auction - U.S. Seeks to Avoid Big Overpayments for Distressed Debt, THE WALL STREET JOURNAL (Sept. 25, 2008), *see also* Chantale LaCasse, Marcia Kramer Mayer, Arun Sen, and Elaine Buckberg, *Buying the Bad Stuff: Implementation Consideration for the Paulson Plan*, NERA ECONOMIC CONSULTING (Sept. 27, 2008).

[24] Some commentators have suggested that the Treasury (and accordingly, taxpayers) might have even realized a profit on large-scale purchases of MBS (had such purchases occurred) because of the substantial difference between current "paper losses" on the securities and projected eventual losses on the underlying mortgages. *See* Jonathan R. Laing, *Making a Mint*, BARRON'S (Sept. 29, 2008).

[25] Testifying before Congress on September 23, 2008, Chairman Bernanke suggested that the Treasury Department might have been willing to pay as much as the "hold-to-maturity" price for troubled assets, including MBS, the price at which financial institutions value assets that they do not intend to sell or trade on secondary markets, as opposed to the "fire sale" prices that have been assigned to MBS and other mortgagerelated assets in the absence of a functioning secondary market. Specifically, Chairman Bernanke stated: "If the Treasury bids for them and buys assets at a price close to the hold-to-maturity price, there will be substantial benefits. First, the banks will have a basis for valuing those assets and will not have to use fire-sale prices. Their capital will not be unreasonably marked down." *See* Jessica Holzer, *Bailout May Aid Bank Balance Sheets,* THE WALL STREET JOURNAL (Sept. 24, 2008); Vikas Bajaj, *Rescue Plan's Basic Mystery: What's All This Stuff Worth?*, NEW YORK TIMES (Sept. 25, 2008).

any given point in time can be determined quickly and reliably.

Because such equity "stock drop" cases make up the majority of securities fraud actions under both the '33 Act and '34 Act, judicial and academic treatment of damages issues has often assumed the existence of an economic loss (typically by reference to a prevailing "market" price) and focused exclusively on related questions of causation. In the context of securities fraud claims involving publicly traded securities, courts have long held that only actual damages, corresponding to the extent to which a plaintiff is damaged as a result of a defendant's fraudulent conduct, are recoverable.[26] The term "actual damages" has been interpreted to mean some reasonable form of economic loss – speculative loses are not compensable.[27]

Because there is no secondary market for most MBS offerings and trades are not publicly reported, proving that an MBS purchaser has suffered an actual economic loss may be more difficult.[28] Indeed, even in cases involving publicly traded equities, courts have long recognized that "market prices" are not an appropriate determinant of "fair value" where equity securities are not actively traded or there is no "true" market.[29] The situation with respect to MBS is, if anything, worse. As discussed above, there is nothing to stop one MBS investor - who may be a named or unnamed plaintiff in a '33 Act class action - from taking a greater GAAP mark-down on a mortgage-backed security than other investors might deem necessary or even appropriate. In such a circumstance, it would seem illogical to allow that plaintiff to claim greater losses as a result.[30] Similarly, after initially writing down the value of a particular MBS, an investor could decide (or feel compelled by GAAP) to later write up the value of a security as a result of changing market conditions or intervening events that affect the performance of the underlying mortgages (for example, many MBS deals permit defaulted mortgages in a pool to be repurchased or substituted). In such a situation, would a plaintiff's losses be reduced accordingly, or its lawsuit rendered

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26 *See*, *e.g.,* Dura Pharmaceuticals, Inc, v. Broudo, 544 U.S. 336, 343-44 (2005) (private securities fraud claims resemble common law deceit and misrepresentation claims, which require a plaintiff to show that it suffered an actual economic loss); Pelletier v. Stuart-James Co., Inc., 863 F.2d 1550, 1557 (11th Cir. 1989) (citing and applying damages standard in 5 U.S.C. § 78bb(a)); Harris v. Union Elec. Co., 787 F.2d 355, 367 (8th Cir. 1986) (same). Section 28(a) of the '34 Act provides, inter alia, that "no person permitted to maintain a suit for damages under the provisions of this title shall recover, through satisfaction of a judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." Section 11(e) of the '33 Act creates a measure of damages that is (i) capped by the offering price and (ii) otherwise based on the purchase and sale price or "value" of the securities, which is analytically consistent with Section 28(a)'s actual damages requirement.

27 *See* Pelletier, 863 F.2d at 1557-58; *see* also Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 259 F.3d 154, 177-78 (3d Cir. 2001). The usual measure of damages in '34 Act cases is out-of-pocket losses – generally (i) the difference between the price paid for the security and what the fair value for the security would have been at the time of purchase absent the fraud or (ii) the difference between the purchase price and sale price, if the stock was sold after the alleged fraud was revealed. *See* Affiliated Ute Citizens of Utah v. U.S., 406 U.S. 128, 155 (1972); Pelletier, 863 F.2d at 1557-58.

28 At least one court has noted that "[v]aluation of mortgage-backed securities … is essentially an exercise in estimating expected future cash flows. By the express terms of the GAAP pronouncements that govern accounting for these securities, a number of variables must be assessed in making such estimates." *In re First Union Corp. Securities Litigation*, 128 F. Supp. 2d 871, 894 n. 22 (W.D.N.C. 2001).

29 *See* Arnold S. Jacobs, 5E Disclosure & Remedies Under the Sec. Laws § 20:64 (2008) (collecting cases).

30 Indeed, one could argue that the text of Section 11(e) itself precludes this by limiting potential damages when a security is sold after an action is commenced. Analytically, there seems to be no more reason to allow plaintiff-specific accounting or valuation choices to influence the existence or amount of damages than choices about the timing of sales.

moot? What would happen if that write-up occurred post-judgment?

In light of this wrinkle, as discussed further below, many MBS purchasers - particularly those who continue to hold the securities and have thus far been paid in full - have argued that sections 11 and 12 of the '33 Act (which also allow for rescission of securities purchases) do not require that they demonstrate any actual loss.[31] At first glance, this argument might appear to have some merit. The applicable standard for claiming loss under the '33 Act is less clear than under the '34 Act, primarily because sections 11 and 12 of the '33 Act are silent as to whether a plaintiff must plead and prove that it has suffered an actual economic loss.[32]

But there are good reasons to believe that MBS purchasers advancing '33 Act claims would still be subject to the requirement of proving at least a cognizable actual economic loss. Both sections 11 and 12 provide for the defense of negative causation, whereby some or all of the damages claimed by a plaintiff may be disallowed if the defendant can prove that "any portion or all of such damages represents other than the depreciation of the value of the security" resulting from alleged misstatements or omissions. The negative causation provisions presume some showing by a plaintiff of a depreciation in the value of the underlying securities, or, put differently, that there has been some economic loss. Otherwise there would be no reason to have included them and/or they would not be considered affirmative defenses.[33] Indeed, these provisions provide a compelling basis for "reading in" a requirement of actual economic loss. For this reason, courts have been willing to dismiss section 11 and 12 claims in circumstances where it is apparent from the pleadings that plaintiff could not have conceivably suffered damages.[34]

The Supreme Court's recent decision in *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (2009), which interpreted Fed. R. Civ. P. 8 rather than Rule 9(b) or the PSLRA, provides additional support for this mode of analysis. *Iqbal* made clear that federal pleading standards "demand more than an unadorned, the defendant-unlawfully-harmed-me accusation" and instead require a complaint to contain "sufficient factual material, accepted as true, to state a claim to relief that is plausible on its face."[35] The mere possibility of liability - well-pled facts "that are merely consistent with a defendant's liability" - are not sufficient at the base level of pleading a claim under Rule 8.[36]

In light of the Supreme Court's direction to assess the plausibility of a case at the motion to dismiss stage, consider the following scenario: A plaintiff has purchased a particular tranche of an MBS offering and still holds the security. The plaintiff knows what it paid for the security, knows the price at which it is currently valuing the security based on whatever rules apply to it, knows how much principal and interest it should have received

[31] *See* cases cited *supra* note 3.

[32] Section 11 assesses damages based on the value of a security at the time the suit is filed, rather than the value of the security at the time of purchase, whereas section 12 provides plaintiffs who have not sold their securities with the right to seek rescissory damages. *Compare* 15 U.S.C. § 77k(e) with 15 U.S.C. § 771 and *Randall v. Loftsgaarden*, 478 U.S. 647, 655-56 (1986).

[33] *See generally Sterten v. Option One Mortgage Corp.*, 479 F. Supp. 2d 479,482 (E.D. Pa. 2007) (affirmative defenses raise new facts that, if proven, defeat a plaintiffs claim even if the allegations in his or her complaint are true).

[34] *See, e.g., In re Initial Public Offering Securities Litigation*, 544 F. Supp. 2d 277, 299 (S.D.N.Y. 2008) ("If a plaintiff has no conceivable damages under Section 11, she cannot state a claim upon which relief can be granted and her Section 11 claims must be dismissed."); *Pierce v. Morris*, 2006 WL 2370343 at *4 (N.D. Tex. August 16, 2006) ("Where a plaintiff fails to allege any conceivable damages for violation of the Securities Act, his claims must be dismissed.").

[35] *See* 129 S. Ct. at 1949.

[36] *See id.*

as a holder of the security, and knows how much principal and interest it has received.[37] Instead of pleading any of those facts, it pleads only that it purchased securities and that the securities "are no longer marketable at prices anywhere near the prices paid by plaintiff and the Class, and the holders of the Certificates are exposed to much more risk with respect to both the timing and absolute cash flow to be received than the Offering Documents represented."[38] Does that state a "plausible" claim under *Iqbal*? It seems more likely that such a claim would be at best "consistent with" liability, which the Supreme Court has now confirmed is not sufficient.[39]

In addition, sections 11 and 12 provide that only misstatements and omissions concerning a "material fact" are actionable. In cases under the anti-fraud provisions of the securities laws, materiality has often been determined by reference to whether the market value of an efficiently traded security declined after the revelation of the allegedly fraudulent conduct.[40] In the case of MBS, however, there is likely to be no discernible secondary market that can serve as an objective indicator of the "market value" of a particular MBS tranche. In this circumstance, courts might well find that a determination of "materiality" must be predicated on the existence of an actual economic loss resulting from the alleged fraudulent and/or negligent conduct. And, importantly, courts might go a step further and conclude that whether a misstatement or omission in an MBS offering document is material can only be determined based on whether the alleged conduct has resulted in a failure to make continued payments of principal and interest, as opposed to whether a subjective "market value" assigned to the security has declined. Beyond the problem of allowing the basis of a claim to be a plaintiff's own determination of the "value" of an asset, the fact that that subjective value can change or even increase while an action is pending - or even later - is an additional reason for caution.

Finally, to the extent that MBS purchasers have received all payments currently due to them, any claim of actual damage would appear to be based solely on the theory that the security's price was inflated at the time of purchase. But the Supreme Court has rejected such a "price inflation theory" in connection with claims under the '34 Act and ruled that the existence of an artificially inflated price does not in itself constitute economic loss sufficient to state a claim under the securities laws.[41] Although *Dura* was a fraud-on-the-market case involving publicly traded securities, there is no reason to believe that the Court would adopt a different standard for the more complex MBS sector. Indeed, the *Dura* Court relied on both the policies behind the securities laws and the common law of deceit and misrepresentation in arriving at its decision, both of which should apply with equal force to claims by MBS purchasers under the '33 Act.[42]

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[37] If the plaintiff does not know these facts, it seems unlikely that it would be deemed an adequate representative for a class seeking to pursue claims relating to such complex securities.

[38] *See NECA-IBEW Health & Welfare Fund v. Goldman, Sachs & Co.*, No. 08-CV-10783 (MGC), Second Amended Complaint 6, 9 (Docket No. 71). Interestingly, the plaintiff in this case pled only the face amount of the securities it purchased, not what it paid for those securities. *See id.* 9.

[39] *See Iqbal*, 129 S. Ct. at 1949.

[40] *See generally Oran v. Stafford,* 226 F.3d 275, 282 (3d Cir. 2000) ("when a stock is traded in an efficient market, the materiality of disclosed information may be measured post hoc by looking to the movement, in the period immediately following disclosure, of the price of the firm's stock").

[41] *Dura Pharmaceuticals, Inc., v. Broudo*, 544 U.S. at 342-44 (2005).

[42] The Second Circuit recently applied Dura in holding that '33 Act claims by in-and-out purchasers should be excluded from a class. *See In re Flag Telecom Holdings, Ltd. Secs. Litig.*, 574 F.3d 29, 37-41 (2d Cir. 2009). Similar arguments might be available (in connection

All of this further confirms that reliance by plaintiffs on "mark-to-model" or "paper" valuations as a basis for claiming actual economic losses raises serious concerns that should be on the minds of counsel representing defendants in section 11 and 12 cases. This, of course, leads to the broader question, discussed below, of whether plaintiffs' claims are even ripe for adjudication where they continue to receive timely principal and interest payments on their MBS holdings.

Ripeness Considerations

To date, only one securities fraud case has directly addressed the issue of whether an MBS holder who continues to be paid in full - or, more precisely, fails to allege that it has not been paid in full - can claim an actual loss based solely on the deterioration of "market prices" for the bond. In *Luminent Mortgage Capital, Inc. v. Merrill Lynch & Co.*[43], a collection of real estate investment trusts sued MBS issuers and underwriters associated with Merrill Lynch for misrepresentations and omissions in connection with the sale of MBS. Plaintiffs asserted claims under the '34 Act and the '33 Act. The defendants argued that plaintiffs did not plead a sufficient economic loss by alleging solely that they might suffer losses in income stream payments based on deficiencies in the pool of mortgage loans underlying the MBS, as opposed to alleging that they had actually suffered losses at the time of filing suit.[44] Focusing specifically on section 10(b) of the '34 Act- although not necessarily excluding the applicability of its holding to the '33 Act claims - the court agreed, holding that the complaint's allegation that the problematic characteristics of the mortgage loans might hypothetically cause plaintiffs a future loss was insufficient to state a claim for securities fraud.[45] The court found that the amended complaint required it to "assume" that plaintiffs received less income on their MBS holdings through "vague and boilerplate invocations of economic loss," and that this was not enough: "Plaintiffs must allege more than a tendency to cause economic loss. Plaintiffs must allege an economic loss."[46]

The above considerations, coupled with the *Luminent* decision, suggest that counsel for issuers or underwriters in '33 Act subprime cases should in each instance step back and evaluate whether plaintiffs - including each member of a putative class - have to date been paid in full. If so, such actions may potentially be subject to dismissal on ripeness grounds, notwithstanding any asserted decline in the "prices" for the securities.[47]

In order for a federal court to have subject matter jurisdiction over a claim under Article III of the Constitution, the claim must present a controversy that is ripe for adjudication. The underlying purpose of the ripeness doctrine "is to prevent the courts, through avoidance of premature adjudication, from entangling themselves in abstract disagreements."[48] Whether a claim is ripe for adjudication depends on whether a matter involves uncertain or "contingent future events that may not occur as anticipated, or indeed may

with motions to dismiss or opposition to class certification) in MBS-related cases.

43 2009 WL 2590087, at *13-14 (E.D.Pa. Aug. 20, 2009).

44 *Id.* at *14.

45 *Id.*

46 *Id.*

47 The discussion that follows assumes that ripeness considerations are addressed under the federal constitution. It is beyond the scope of this article to address whether ripeness would be a state or federal constitutional issue were '33 Act claims to be pursued in state courts.

48 *Pacific Gas & Elec. Co. v. State Energy Resources Comm.*, 461 U.S. 190, 200-01 (1983) (quoting *Abbott Laboratories v. Gardner*, 387 U.S. 136, 148-149 (1967)).

not occur at all."[49] Although there is a scarcity of securities law decisions addressing ripeness issues, in other contexts courts have routinely dismissed tort claims as unripe where plaintiffs had not yet suffered any injury or accrued actual damages.[50]

In this regard, cases brought under the Racketeer Influenced and Corrupt Organizations Act involving loans are particularly instructive.[51] For example, in *First Nationwide Bank v. Gelt Funding Corp.*,[52] the Second Circuit considered whether First Nationwide Bank ("FNB") could state a fraud-based RICO claim before it had realized any actual loss as a result of the allegedly fraudulent conduct.[53] FNB alleged that it was fraudulently induced to make certain nonrecourse loans to defendants based on misrepresentations concerning the value of properties pledged as collateral to secure the loans.[54] FNB argued that its fraud claims were ripe for adjudication because it had suffered "immediate quantifiable injury when the loans were made because the loans were undersecured" and "FNB assumed additional risk of loss."[55] It contended that these claims were ripe regardless of whether the borrowers were yet in default or whether FNB had completed proceedings to foreclose on the properties pledged as collateral.[56]

The Second Circuit found these arguments unpersuasive, noting that "as a general rule, a cause of action does not accrue under RICO until the amount of damages becomes clear and definite."[57] The court reasoned that any amounts potentially recovered by FNB from defendants or through foreclosure on the collateral would serve to reduce the amount of damages to which it was entitled, and accordingly, "the amount of loss cannot be established until it is finally determined whether the collateral is sufficient to make the plaintiff whole, and if so, by how much."[58] Thus, the court rejected "FNB's novel theory that it was damaged simply by being undersecured, when, with respect to those loans not yet foreclosed, the actual damages it will suffer, if any, are yet to be determined."[59] It further held that "to the extent FNB's complaint is predicated on loans that have not been foreclosed, its claims are not ripe for

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[49] *Texas v. U.S.*, 523 U.S. 296, 300 (1998) (quoting 13A Charles A. Wright, Arthur R. Miller, and Edward H. Cooper, Federal Practice and Procedure § 3532, p. 112 (1984)).

[50] S*ee, e.g., Midwest Commerce Banking Co. v. Elkhart City Center,* 4 F.3d 521, 526 (7th Cir. 1993) (Posner, J.) ("Damages are for people who have been harmed. You cannot seek an award of damages for a fraud, therefore, before the fraud has harmed you. Even if there has been harm, if it cannot yet be quantified, a damages suit may be premature."); J*ackson National Life Insurance Co. v. Ligator*, 949 F. Supp. 200 (dismissing lender's fraud and negligent misrepresentation claims as premature because the mere "unlikelihood" that defendants would be able to satisfy notes when due was insufficient to support an action); *Plummer v. Abbott Laboratories*, 568 F. Supp. 920, 922 (D.R.I. 1983) ("It is an abecedarian principle of tort law that an individual must be injured to recover for the negligent acts of another."); *see generally* CJS FRAUD § 70 ("A contingent injury, where loss may or may not occur, is insufficient to support a recovery for fraud.").

[51] To have standing to bring a private fraud action under RICO, a plaintiff must demonstrate: "(1) a violation of section 1962 [of RICO]; (2) injury to business or property; and (3) causation of the injury by the violation." *Motorola Credit Corp. v. Uzan*, 322 F.3d 130, 135 (2d Cir. 2003) (quoting *Hecht v. Commerce Clearing House, Inc.*, 897 F.2d 21, 23 (2d. Cir. 1990)).

[52] 27 F.3d 763 (2d Cir. 1994).

[53] Actual losses for the purposes of RICO means financial losses. *See Berg v. First State Ins. Co.*, 915 F.2d 460, 464 (9th Cir. 1990).

[54] *First Nationwide Bank*, 27 F.3d at 764-67.

[55] *Id.* at 767-68.

[56] *Id.* at 767.

[57] *Id.*; *see also Cruden v. Bank of New York*, 957 F.2d 961, 978 (2d Cir. 1992) (holding that debenture holder plaintiffs were injured within meaning of RICO only when companies which guaranteed principal and interest on debentures defaulted).

[58] *Id.*

[59] *Id.* at 768.

adjudication because it is uncertain whether FNB will sustain any injury cognizable under RICO."[60]

In another RICO case before the Second Circuit, *Motorola Credit Corporation v. Uzan*,[61] the plaintiffs sought to recover for a third-party's failure to repay loans and for actions to dilute the value of stock securing those loans.[62] Relying heavily on *First Nationwide Bank*, the court concluded that the plaintiffs lacked standing to assert RICO claims because their claims were not ripe insofar as plaintiffs had not yet foreclosed on the loans at issue.[63] Thus, the court found that "a plaintiff who claims that a debt is uncollectible because of the defendant's conduct can only pursue the RICO treble damages remedy after his contractual rights to payment have been frustrated."[64]

Similarly, in *American Home Mortgage Corp. v. UM Securities Corp.*,[65] a plaintiff mortgage lender sued a mortgage broker and other related parties under RICO for conspiring to fraudulently obtain loans to purchase nine residential properties. The defendants allegedly accomplished the fraud by, among other things, misrepresenting the market value of the subject properties and submitting fraudulent appraisals, disclosure statements and other documentation.[66] Plaintiff argued that it had suffered compensable damages because the market value of the loans it issued had substantially diminished and that it would not have issued the loans had it known the true market value of the properties in question.[67] The court disagreed and concluded, following *First Nationwide Bank*, that the plaintiff's claims concerning unforeclosed loans and properties were not ripe because the scope of any actual damages that may be suffered in the future had not yet been determined.[68]

The fact patterns in these RICO cases are analogous to the scenario of an MBS purchaser who, despite receiving all payments to which it is entitled, nevertheless claims to have suffered damages as a result of alleged misrepresentations that caused it to assume additional risk of loss. These cases make clear that the speculative fear that a party might suffer a loss - from a deterioration in the value of mortgage collateral in particular - is not sufficient for a tort claim to become ripe. Nor is there generally a basis in law for seeking tort damages where such damages cannot be quantified and may never come to pass.

60 *Id.* at 767. It should be noted that establishing standing under RICO is a "more rigorous matter" than establishing standing under Article III. *Denney v. Deutsche Bank AG*, 443 F.3d 253, 266 (2d Cir. 2006) (citation omitted).

61 322 F.3d 130, *supra note* 34.

62 *Id.* at 132.

63 *Id.* at 135.

64 *Id.* at 136 (quoting *First Nationwide Bank*, 27 F.3d at 768).

65 2007 WL 1074837 (S.D.N.Y. April 9, 2007).

66 *Id.* at *1.

67 *Id.*

68 *Id.* at *4. Numerous other RICO cases are to the same effect. *See, e.g., Lincoln House, Inc. v. Dupre*, 903 F.2d 845, 847 (1st Cir. 1990) (fraud claim under RICO was not ripe for adjudication because "alleged injury [wa]s clearly contingent on events that may not occur as anticipated or may not occur at all."); Cruden, 957 F.2d at 978 ("defendants' RICO violations did not give rise to a claim for relief under § 1964(c) until those violations resulted in an injury to plaintiffs' business or property - when Computer and International defaulted on their principal and/or interest payments"); *Harbinger Capital Partners Master Fund I, Ltd.*, 2008 WL 3925175 at * 4-5 (S.D.N.Y. Aug. 26, 2008) (damages claims of holders of bank debt were unripe because ongoing bankruptcy proceedings may allow for recovery that would offset alleged losses); *Anitora Travel, Inc. v. Lapian,* 677 F.Supp. 209, 216 (S.D.N.Y. 1988) ("a party must actually have been injured - that is, subject to injury or inevitably to be subject to a future injury - in order to have standing to bring a civil RICO claim. Mere speculation that some injury might occur ... is insufficient to state a civil RICO claim").

Tort litigation in other areas provides good examples of how these rules have developed. In cases filed against insurers under the Employee Retirement Income Security Act, courts have held that plaintiffs asserting tort (typically fraudulent inducement) or contract claims do not have standing under Article III until they have sought and been denied benefits.[69] More specifically, the fear that an insurer may deny benefits in the future based on an improper reading of an insurance policy, thus diminishing the policy's "market value," has been rejected as insufficient to show actual injury from fraud.[70] In the context of asbestos-related litigation, courts have held that damages cannot be awarded based on the fear of future illness; there must be a physical manifestation of asbestos-related disease before a plaintiff can bring suit.[71] Similar reasoning would suggest that the types of market-indicator revisions that drive mark-to-market price decreases - essentially fear of the results of current or future economic conditions - ought not be a basis for '33 Act claims.[72]

Recent Developments

Since this article was originally published in January 2009, defendants in several section 11 and 12 cases have focused on the issues raised above, aggressively arguing that MBS purchaser plaintiffs who continue to be paid the full amount of any principal and interest payments due to them have not suffered a legally cognizable injury.[73]

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[69] *See Impress Communications v. UnumProvident Corp.*, 335 F. Supp. 2d 1053,1061 (C.D. Cal 2003) ("In short, whether [p]laintiffs have alleged fraudulent inducement or breach of contract, they have not established injury under Article in. Plaintiffs have never made a claim for benefits that [defendants have failed to honor. Thus, [defendants have not failed to perform, and there can be no breach of contract. Nor have [p]laintiffs suffered injury that could support a claim of fraud."); *Doe v. Blue Cross Blue Shield, of Maryland*, 173 F. Supp. 2d 398, 407 (D.Md. 2001) (dismissing fraud claim against insurer because "promisee does not suffer an injury necessary to trigger a fraud claim based on fraudulent inducement unless and until the promisor actually breaches the contract by failing to perform"); *see also Horvath v. Keystone Health Plan East, Inc.*, 333 F.3d 450, 456-57 (3d Cir. 2003) (denying plaintiffs standing to pursue restitution and disgorgement claims where benefits were not diminished or compromised by defendant's management of healthcare plan and no economic harm had been suffered).

[70] *Impress Communications*, 335 F. Supp. 2d at 1059 (allegation that defendant's administration of disability insurance plan might result in denial of future benefits was "purely speculative" and insufficient to confer Article HI standing); *Doe*, 173 F. Supp. 2d at 406-07 (rejecting theory that present value of insurance policy was diminished because insurer may at some indefinite point in the future deny benefits based upon a restrictive reading of the policy).

[71] *See Berneir v Raymark Indus, Inc.*, 516 A2d 534, 543 (Me. 1986) (under "generally applicable principles of tort law... a judicially recognizable claim does not arise until there has been a manifestation of physical injury to a person, sufficient to cause him actual loss, damage, or suffering"); *Temple-Inland Prods. Corp. v. Carter*, 993 SW2d 88, 91-95 (Tex. 1999) (damages for fear of future asbestos-related disease are not recoverable absent a present bodily injury); *Metro-North Commuter R.R. Co. v. Buckley*, 521 U.S. 424, 429 (1997); *Schweitzer v. Consolidated Rail Corp.*, 758 F.2d 936, 942 (3d Cir. 1985); *Gideon v. Johns-Manville Sales Corp.*, 761 F.2d 1129, 1136 (5th Cir. 1985).

[72] Another aspect of the ripeness issue that may be unique to the current crisis is the possibility that future legislative action or policy choices may ameliorate some or all of the bases for fears that defaults and foreclosures will increase. To the extent that government action, whether federal, state, or both, reduces foreclosure rates or causes homes to retain or even increase in value, the collateral underlying many mortgage-backed securities may be more valuable. At the very least, such events (if they come to pass) will have to be reflected in valuations of MBS portfolios, just as markets often "price in" views regarding anticipated monetary policies.

[73] *E.g., Plumbers' Union Local No. 12 Pension Fund v. Nomura Asset Acceptance Corp. et al.*, No. 08-cv-10446 (D. Mass); NECA-IBEW *Health & Welfare Fund v. Goldman Sachs & Co.*, No. 08-cv-10783 (S.D.N.Y.); *New Jersey Carpenters Health Fund v. DLJ Mortgage Capital, Inc., et al.*, No. 08-cv-05653 (S.D.N.Y.); *Tsereteli and Vaszurele Ltd. v. Residential Asset Securitization Trust* 2006-A8 et al., No. 08-cv-10637 (S.D.N.Y).

For example, in *Nomura Asset Acceptance Corp.*, plaintiffs, on behalf of a putative class of MBS investors, brought claims under Sections 11, 12(a)(2), and 15 of the '33 Act alleging misrepresentations and omissions in the offering materials pursuant to which they purchased their securities. In their motion to dismiss the consolidated amended complaint, defendants Nomura Asset Acceptance Corp, the issuing trusts, and the underwriters argued, *inter alia*, that plaintiffs failed to adequately plead damages because they did not allege that they had failed to receive any interest and principal payments due to them.[74] Citing extensively to both *First Nationwide Bank*[75] and the initial version of this article, defendants argued that (1) plaintiffs' claims were premature insofar as they had received all payments to which they were contractually entitled; (2) mortgage-backed securities are fundamentally different from publicly traded equity securities or bonds for which there are discernible market prices; (3) the "market value" of MBS purchased by plaintiffs cannot be used as a fair measure of loss, particularly where the governing offering documents made clear that no secondary market for the securities may exist; and (4) plaintiffs could not properly assert an actual economic loss based solely on an alleged increased risk that their securities would not perform as expected in the future.[76]

Although *Nomura Asset Acceptance Corp.* was ultimately dismissed on other grounds and without addressing the damages issues, motions to dismiss on virtually identical grounds are pending in several similar cases and may soon lead to substantive judicial treatment of the issues raised above. For example, in *New Jersey Carpenters*, a group of defendants have also moved to dismiss section 11 and 12 claims on the basis of plaintiff's failure to allege that it had received less income than it was owed under the terms of the securities, notwithstanding a substantial decline in their "market value."[77] Defendants, again with citation to this article, argued in their opening brief:

> Plaintiffs' allegations are insufficient because it has not alleged it failed to receive any of the principal or interest payments to which it is entitled pursuant to the Certificates. Instead, plaintiff bases its claim of injury on the singular allegation that its holdings 'have lost 79% of their total value.' Although not explicitly stated in the Amended Complaint, Plaintiff's real dissatisfaction seems to be that it is having trouble reselling the Certificates in the secondary market at a price Plaintiff finds acceptable. However, the value of the Certificates is derived from the future cash flows generated by the underlying pools of securitized mortgages, discounted to their

[74] Memorandum of Law in Support of Defendants' Motion Pursuant to Rule 12(b)(6) to Dismiss the Consolidated Amended Complaint for Failure to State a Claim, filed March 13, 2009, at 25-28 (Docket No. 41).

[75] Two recent decisions, *Luminent* (*supra* note 43) and *In re First Marblehead Corp. Securities Litigation*, 639 F.Supp.2d 145 (D.Mass. 2009), have also relied on *First Nationwide Bank* in dismissing securities fraud claims by MBS investors on loss causation grounds. In these cases, the courts determined that the overall economic downtown, rather than fraud, was likely responsible for losses allegedly incurred by plaintiffs, based on *First Nationwide Bank's* holding that "when the plaintiff's loss coincides with a marketwide phenomenon causing comparable losses to other investors, the prospect that plaintiffs' loss was caused by fraud decreases." Accordingly, the argument that any harm to MBS investors may have been caused by prevailing market conditions as opposed to misconduct by defendants, especially where, as here, the global economic crisis cannot be seriously disputed, will likely be relied on by many defendants in securities cases going forward.

[76] *Supra* note 74 at 25-28.

[77] Defendants' Memorandum of Law in Support of Motion to Dismiss Amended Complaint, filed June 24, 2009, at 8-9, 10-12 (Docket No. 55).

present value - not from their perceived market value.[78]

The same arguments were also featured in a pending motion to dismiss by defendants in *Tsereteli*, where defendants pointedly noted that "it makes no sense for [p]laintiffs to claim 'damages' based on the current illiquid market for mortgage-backed securities when they were explicitly told that a secondary market...might *never* exist."[79] Moreover, in *NECA-IBEW*, a case pending before Judge Cederbaum in the District Court for the Southern District of New York, the defendants succeeded in obtaining dismissal, with leave to replead, of section 11 and 12 claims arising from their roles as MBS issuers and underwriters.[80] Although there was not a written decision articulating the precise grounds for dismissal, the court may have accepted the argument, relying on *First Nationwide Bank*, that "[i]nvestors in mortgage-backed securities [ ] can suffer 'damages' only when they do not receive 'pass through' cash-flow payments to which they are entitled."[81] Plaintiffs have since filed a Second Amended Complaint, which will almost certainly subject to a further motion to dismiss and, accordingly, a potential ruling from the court specifically addressing this issue.

The primary responses to these arguments offered by plaintiffs have been that (1) sections 11 and 12 of the '33 Act require nothing more, at the pleading stage, than alleging facts that create a reasonable inference that the value (measured by "market price") of the MBS at issue has diminished; (2) determination of the "value" of an MBS is a "fact intensive issue" that cannot be resolved at the pleading stage; and (3) that the warnings in MBS offering documents that a secondary market for the securities does not (or may not) exist are "boilerplate" statements that cannot be relied upon, as a matter of law, to establish that the securities in question have no intrinsic "value" beyond the income stream payments to which holders are entitled.[82] Although it remains to be seen how courts will resolve these issues, plaintiffs' success or failure will turn on (i) how *Iqbal* fits into the picture[83] and (ii) whether courts are willing to rigidly apply the '33 Act's prescribed valuation methodology, which was designed for conventional equity securities with discernible market prices, notwithstanding the fact that MBS have many unique features that may warrant a different approach to assessing whether plaintiffs have suffered an actual economic loss.[84]

Conclusion

Assessing whether MBS purchasers who continue to be paid in full (or have not yet suffered losses beyond what income was

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78 *Id.* at 11 (citations omitted).

79 *Supra* note 10 at 23-24.

80 *See* Endorsed Notice of Motion granting motion to dismiss with leave to plaintiff to file and serve an amended complaint by no later that November 9, 2009, entered September 18, 2009 (Docket No. 66).

81 Memorandum of Law in Support of Defendants' Motion to Dismiss the Amended Complaint, filed August 20, 2009, at 15 (Docket No. 60)

82 *See, e.g., NECA-IBEW*, Memorandum of Law in Opposition to Defendants' Motion to Dismiss the Amended Complaint for Violation of §§ 11, 12(a)(2) and 15 of the Securities Act of 1933, filed September 9, 2009, at 32-25 (Docket No. 62).

83 For example, one response to a plaintiff's assertion that pleading the existence of damages is all that is necessary might be to ask a court to suspend all aspects of the case except discovery relating to whether a loss was suffered, and to permit expedited summary judgment briefing on that issue. This would likely be dispositive of the entire case and be consistent with courts' growing desire not to subject parties to burdensome and expensive discovery for claims that are not plausible.

84 Put differently, when the '33 Act was enacted, structures like MBS were decades away from being conceived. Indeed, the theoretical bases for valuing the inherent optionality in MBS did not even exist, to say nothing of the computational resources necessary for such valuation.

projected for their securities at any given time) have suffered loss for the purposes of the securities laws has and will likely continue to present thorny questions for litigants and the courts. Ultimately, application of the securities laws when "market" prices are absent may be deeply problematic. In the first instance, courts may need to grapple with whether (and if so, how) it makes sense to apply the '33 Act to securities that are not publicly traded and whose value is not defined by easily ascertainable public sale prices.

As discussed above, an MBS is in essence a contractual interest in a share of the income stream from the mortgages collateralizing the security, and this contractual interest is fundamentally different from the interest an investor has in an equity security or even many corporate bonds. Accordingly, as the above discussion illustrates, the key question is whether it makes sense to allow a party that is still getting exactly what it paid for under a contract to sue under the securities laws because of a change in the risks associated with the likelihood of future contractual performance. Indeed, as with any contract suit, it may well be that an MBS purchaser suffers a "loss" only when there has been a clear failure to perform (i.e., by failing to make the requisite payments of principal and interest at the requisite time) and that the consideration one might receive from a hypothetical third party for selling or assigning one's contractual rights is irrelevant to whether a claim can be pleaded under the securities laws.

Under such circumstances, investor plaintiffs may have little choice but to "wait and see" whether feared, modeled, or projected losses on their MBS portfolios come to fruition (*i.e.*, become "clear and definite") before being able to state claims under the securities laws.[85] This is especially true where, as here, intervening events such as legislative or executive action directed at curbing mortgage default rates, changes in prevailing interest rates, or other macroeconomic events (domestic or global) could drastically alter the future payment outlook for many mortgage-backed securities.

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[85] Plaintiffs faced with such challenges will likely be concerned with the applicable statute of limitations (two years from discovery of the violation or a maximum of five years from the violation, as amended by the Sarbanes-Oxley Act), which could potentially expire before the extent of actual MBS losses, if any, are determined. Although this topic is beyond the scope of this article, the constitutional requirement that a federal court may only exercise subject matter jurisdiction over a claim that is ripe for adjudication cannot be relaxed to accommodate a statutory limitations period (which was presumably enacted with the constitutional restrictions in mind). Assuming that the claims of some MBS purchasers are deemed to have not accrued within the statute of limitations period, such claims may arguably be lost. *See MSI Pillars, Ltd. v. City Commission of Springfield, Ohio*, 2008 WL 4449273 at *3 (S.D. Ohio Sept. 30, 2008) (federal court may not create exception to ripeness doctrine in order to prevent statute of limitations from running).

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